No. 10167

In the United States Circuit Court of Appeals for the Ninth Circuit

Commissioner of Internal Revenue, petitioner

v.

Columbia National Bank, a Corporation, respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

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CITATIONS

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OPINION BELOW

The memorandum opinion of the Board of Tax Appeals (R. 19–20) is not officially reported.

JURISDICTION

This review involves income tax for 1939. (R. 22–23.) The Commissioner's deficiency letter to the taxpayer was issued on November 22, 1940 (R. 9–10), and a petition to the Board of Tax Appeals was filed by the taxpayer on February 10, 1941 (R. 1), which was within the period allowed by Section 272 (a) (1) of the Internal Revenue Code. This review is taken from the Board's decision entered February 26, 1942, allowing a deficiency of $13.14. (R. 20.) The peti-

tion for review by this Court was filed May 15, 1942 (R. 21–25), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the taxpayer is subject to income tax on amounts recovered in 1939 on debts which were charged off as worthless and deducted on its income tax returns for five prior years.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from * * * the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (U. S. C. 1940 ed., Title 26, Sec. 22.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period. (U. S. C. 1940 ed., Title 26, Sec. 42.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

> Sec. 19.23 (k)–1. *Bad debts.*—* * *
>
> * * * * *
>
> Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. * * *
>
> * * * * *
>
> Sec. 19.42–1. *When included in gross income.*—* * * Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. * * *

STATEMENT

The Board of Tax Appeals found that the Commissioner determined a deficiency of $1,921.92 in the taxpayer's income tax for 1939 by including in its gross income the amount of $11,568.39, which was recovered in that year from debts charged off and deducted in 1930, 1934, 1935, 1936 and 1937; and that the total amount of debts charged off in those earlier years was greater than the net losses sustained in such years. (R. 19.)

The pertinent figures, covering these years, were stipulated by the parties and adopted by the Board. (R. 19.) They are as follows (R. 16):

Years	Debts charged off	Net losses
1930	$98, 674. 20	$43, 634. 92
1934	91, 394. 63	89, 529. 75
1935	17, 968. 90	7, 487. 59
1936	26, 889. 70	3, 758. 83
1937	31, 705. 87	12, 621. 71

The recoveries which the taxpayer made in 1939 on the above debts were as follows (R. 16):

On bad debts charged off in 1930	$7, 699. 20
" " " " " " 1934	1, 512. 61
" " " " " " 1935	25. 00
" " " " " " 1936	1, 291. 58
" " " " " " 1937	1, 070. 00
Total	$11, 568. 39

The Board held that the above sums recovered in 1939 were not taxable and so held that there was a deficiency of only $13.14 in income tax for that year. (R. 20.)

STATEMENT OF POINTS TO BE URGED

1. The Board erred in failing to hold that the amount of $11,568.39 recovered by the taxpayer in 1939 on account of bad debt losses claimed and allowed as deductions from gross income in determining income tax liabilities for prior years constituted taxable income for the calendar year 1939.

2. The Board erred in failing to enter a decision determining that there is a deficiency in income tax in the amount of $1,921.92 for the calendar year 1939.

SUMMARY OF ARGUMENT

It is well settled that where amounts are previously deducted for bad debts, recoveries in later years on account of such deductions are returnable as a part of gross income for the year in which recovered.

Thus, the Board erred in deciding that the sums recovered here in the taxable year did not constitute taxable income. In order to apply the above rule, it is not necessary to show that the taxpayer had net income after taking the deductions and that it received a tax benefit from such deductions. Accordingly, it is not material that net losses were sustained here in the years that the debts were deducted. However, the Board considered such net losses a controlling factor and the effect of its decision is to allow the taxpayer to carry over such losses to the year of recovery, and to offset the losses against the amounts recovered. No statutory provision authorizes such treatment for net losses, and the taxpayer should not be allowed to take what amounts to a deduction in the taxable year when there is no specific authority for such action.

Furthermore, while these debts were first treated as assets, they were charged off and deducted in prior years. Thus, the taxpayer elected to eliminate them from its capital account and so the recoveries in the taxable year were received as income for tax purposes. This view is in accord with the established practice of treating each year as an independent unit.

ARGUMENT

The Board erred in holding that the sums recovered in the taxable year on bad debts charged off and deducted in prior years were not subject to income tax

The only question here is whether the sum of $11,568.39, which the taxpayer recovered in 1939 on debts charged off and deducted as worthless in several

prior years, should be treated as taxable income in 1939. For many years the Treasury Regulations have provided that amounts recovered on bad debts previously deducted must be included in gross income in the year of recovery. See Section 19.23 (k)–1 and Section 19.42–1 of Treasury Regulations 103, *supra;* also see Article 52 of Treasury Regulations 45, Article 151 of Treasury Regulations 62, 65 and 69, Article 33 of Treasury Regulations 74 and 77, Article 23 (k)–1 of Treasury Regulations 86 and 94, and Article 23 (k)–1(b) of Treasury Regulations 101. These regulations are valid and come well within the statutory definition of gross income. *Commissioner* v. *State-Planters Bank & Trust Co.* (C. C. A. 4th), decided August 18, 1942 (1942 C. C. H., Par. 9633); *Commissioner* v. *Liberty Bank & Trust Co.,* 59 F. 2d 320 (C. C. A. 6th); *Askin & Marine Co.* v. *Commissioner,* 66 F. 2d 776 (C. C. A. 2d). The pinciple announced in these regulations has also been approved in other decisions. *S. Rossin & Sons* v. *Commissioner,* 113 F. 2d 652 (C. C. A. 2d); *Putnam Nat. Bank* v. *Commissioner,* 50 F. 2d 158 (C. C. A. 5th).

Although the above regulations contain no qualifying provisions, it will doubtless be argued here, as it was in the *State-Planters Bank* case, that the general language of the regulations must be interpreted as meaning that such recovered sums can be included in gross income only when the prior debt deductions have resulted in a tax benefit to the taxpayer. In other words, when net losses are sustained in the year that the deductions are taken, it has been argued that

subsequent recoveries are not taxable. That is, in effect, the holding of the Board in the instant case. But the court held in the *State-Planters Bank* case, which also involved net losses, that such an interpretation of the regulations is unwarranted since there is nothing therein or in any statute which makes the taxability of recoveries on bad debts dependent upon whether a tax benefit has resulted from the prior deductions. In so holding, the court gave an explanation of the basic theory of such cases, which we quote here in full since it is a clear expression of our position in the instant case. It said:

> It is to be noted that only where the bad debt has been charged off and allowed as a deduction is it to be included in income when collected. The taxpayer is thus given an option by the statute and, only where he exercises the option, is he required to account for the collection as income. Where he does exercise it, however, by charging off the debt as worthless in his return, he is bound by the election so made. * * * When he collects the debt thereafter he must account for the collection as income; for by electing to charge it off, he is precluded from treating it as capital or its collection as the restoration of capital and under the existing regulation impliedly consents that it be treated as income. When a debt has thus been charged off in one year and collected in a subsequent year, the fact that such charge off did or did not result in tax benefit cannot be considered in connection with the taxability of its collection as income both because the taxability is determined by the

> charge off and not by the tax benefit accruing therefrom and because each taxable year must be regarded as an independent unit for income tax purposes. *Burnet* v. *Sanford & Brooks Co.* 282 U. S. 359.

In rejecting the contention that a bad debt constitutes a capital loss and that any recovery thereon is merely a restoration of capital, the court stated further that—

> This, however, not only ignores the fact that the taxpayer elects, by charging off the debt, to eliminate it as a capital item and treat any possible collection of it as income, but, in the case of a business, is clearly contrary to proper accounting theory and practice. Bad debts are ordinarily treated as operating expense of a business in arriving at net operating gain or loss; and consequently a recovery on debts previously charged off is properly treated as income rather than as a return of capital, irrespective of what effect the charge off may have had upon income tax. The statutory provision for deduction of bad debts and the regulation requiring subsequent recovery thereon to be included in gross income is but recognition of this well established accounting practice. * * *

Thus, it is our position that since the taxpayer charged off the debts involved here and deducted them on its income tax returns, it made an election to eliminate such debts from its capital account[1] and

[1] From testimony of taxpayer's witness, it actually appears that its treatment of the debts is in accord with our position. (R. 36, 40.)

any subsequent collections thereon must be treated as income. Also in accord, see *Stearns Coal & Lumber Co.* v. *Glenn,* 42 F. Supp. 28 (W. D. Ky.), pending on taxpayer's appeal in the Circuit Court of Appeals for the Sixth Circuit, and G. C. M. 22163, 1940–2 Cum. Bull. 76.[2]

As further support for our position here, we call attention to the fact that all revenue statutes have uniformly assessed income tax on the basis of annual returns. This means that each year is to be treated as an independent unit in computing income tax. *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359. Consequently, the question of a tax benefit in the year a deduction is taken for a bad debt cannot properly be considered in determining whether recoveries on such debt in a later year are to be included in gross income.

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[2] As to the proper accounting practice relative to bad debts, the above ruling states (p. 79):

> Bad debts charged off in any business are deductible under a specific provision of the Revenue Acts rather than as ordinary and necessary business expenses. They are, nevertheless, under well-established accounting practices, recognized as operating expenses of the business deductible as such in arriving at the net operating gain or loss for the periods involved. See Finney, Principles of Accounting, 1934 Edition, Volume I, page 37, and Kester, Principles of Accounting, Fourth Edition, pages 46, 116, and 554. Consequently, the amount represented by debts which become worthless and are charged off in the carrying on of a trade or business is not to be considered as an investment of capital which must first be returned in full before taxable income is derived. Under this principle, amounts recovered in any taxable year upon debts previously charged off and allowed as a deduction should be treated as taxable income regardless of whether the prior allowance of the deduction resulted in a tax benefit to the taxpayer.

The amount recovered in the case of *Sanford & Brooks Co.* related to construction losses deducted in several prior years. There the taxpayer had entered into a dredging contract with the United States and had performed under the contract for four years, but after its tax returns for 1913, 1915 and 1916 showed net losses, it brought suit against the United States to recover the difference between the amounts received under the contract and the amounts it had spent in carrying on its work. A judgment was entered in favor of the taxpayer in 1920 for an amount equal to that which it was claiming, plus interest. The taxpayer contended that the former amount was not taxable because it represented merely a return of the earlier losses, but the Supreme Court decided that such sum was taxable. The Court said (pp. 364–365):

> That such receipts from the conduct of a business enterprise are to be included in the taxpayer's return as a part of gross income, regardless of whether the particular transaction results in net profit, sufficiently appears from the quoted words of § 213 (a) and from the character of the deductions allowed. * * * The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.
>
> * * * * *
>
> A taxpayer may be in receipt of net income in one year and not in another. The net result

> of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

While the Supreme Court indicated there that net losses could not be carried forward to be offset against income received several years later, that is the effect of the Board's decision here. In other words, the actual result of the Board's holding is that net losses which were sustained by the taxpayer in 1930, 1934, 1935, 1936 and 1937 can be carried over to 1939 and then offset against the amount recovered in that year. No revenue statute has ever allowed net losses to be carried over for more than two years or in such a manner, and some have made no allowance whatsover for net losses. Thus, since Congress has provided for net losses in some statutes and omitted such provisions from others, it may not be assumed that any loss can be carried over in the absence of specific authorization or that the same result may be indirectly accomplished by allowing a net loss in some prior year to be carried forward to whatever future time that a recovery may be made on a debt and then offset the recovered sum and prevent its being treated as income.[3]

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[3] Section 114 of the pending Revenue Bill of 1942 proposes an amendment to the definition of gross income in Section 22 of the Internal Revenue Code, which will exclude recoveries on previ-

Application of the rule contended for by the taxpayer and adopted by the Board is moreover based on the false assumption that the mere fact that a taxpayer sustained a net loss in the earlier year means that it derived no tax benefit in that year. But that is obviously not always the case. For instance, where the deductions for bad debts exceed the net losses, which is the situation here, the taxpayer does derive a benefit. In the instant case, the taxpayer actually offset a portion of the debt deductions in each year by gross income and was benefited to that extent. Moreover, the sums recovered in the taxable year on these various charge offs were in each instance smaller than the amount by which the taxpayer was benefited in the prior years.[4] Accordingly, if actual benefit from a deduction ought to be the criterion, then why is the taxpayer here not liable under its own contention for tax upon the total of its recoveries as a

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ously deducted bad debts when the prior deduction did not result in a reduction of the taxpayer's income tax. The proposed amendment provides further that the amount of the recovery to be excluded shall be determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary of the Treasury. The amendment is to be retroactive.

To what extent and in what manner, the proposed legislation might affect the instant case is not known at this time.

[4] To what extent the taxpayer was actually benefited by the deductions is illustrated by the figures for the year 1930, which is typical of the other years. The record shows (R. 16)—

Total debt charge off, 1930	$98, 674. 20
Net loss for 1930	43, 634. 92
Actual benefit	$55, 039. 28
Amount recovered on 1930 charge off	7, 699. 20
Excess after recovery is subtracted	$48, 340. 08

sum in excess of the total recovered was actually subtracted in prior years from its gross income? Certainly it is difficult to see why it should be held, as the Board has done, that the full amount of the net losses must be recovered before any portion of the sums charged off can be included in gross income. Such a holding is, as we have indicated, an allowance of net losses without statutory authority.

The application of the net loss test to determine whether or not a tax benefit was secured also involves another fallacy, namely, that the bad debt deduction is the last deduction taken on the return and so is the cause of the net loss. As a taxpayer usually has several kinds of deductions, and as there is no rule of priority which requires gross income to be offset first by deductions not relating to bad debts, a net loss is obviously not the result of one deduction, but of several. Consequently, if we are required to determine whether a taxpayer has secured any tax benefit from a debt deduction, some method of prorating a net loss among all the deductions should be adopted. While such a rule would be confusing and difficult to administer, it would seem to be necessary if the tax benefit theory is to be fairly applied. Cf. dissenting opinion in *Kennedy Laundry Co.* v. *Commissioner,* 46 B. T. A. 70, 76, pending on appeal in the Circuit Court of Appeals for the Seventh Circuit.

We submit that these illustrations suffice to show that the tax benefit theory, as applied by the Board, is wholly illogical and that the correct view is that the taxpayer has elected, by its deductions for bad debts, to treat any recoveries as income when received.

In taking a contrary view here, the Board relied on five of its own decisions. (R. 19.) One of these is *State-Planters Bank & Trust Co.* v. *Commissioner,* 45 B. T. A. 630, which has since been reversed. Thus, as we have already indicated, that decision is in our favor.

Another case which the Board cites is *National Bank of Commerce* v. *Commissioner,* 40 B. T. A. 72, affirmed by this Court, 115 F. 2d 875, but that case involved different facts and the statutory provisions covering reorganizations. As a part of a reorganization, six banks had conveyed all of their assets to another bank which assumed all of their liabilities. Thereafter, the transferee bank recovered on certain debts which the transferors had already charged off and had deducted in years when the latter had sustained net losses. The transferee bank contended that it was not taxable on the sums recovered because such sums represented a return of its capital. In considering this situation, this Court discussed the regulations relied on herein and gave its approval of them. It also pointed out that if the recoveries had been made by the transferors, the entire amount would of necessity have been included in their returns as income, since the debts involved had been charged off and deducted in prior years. But the Court stated further that since the transferee acquired its right to recover on the transferors' debts by purchase, it was not in the same position as the original debtors or transferors, and so held that the sum recovered by the transferee could be taxed only to the extent of the amount received in excess of cost.

However, this Court found that the debts, having been charged off of the transferors' books prior to the reorganization, had cost the transferee nothing, and so held that the latter was taxable on the whole amount recovered. Thus, such holding, to the extent that it is in point, actually supports our contention here, for it indicated very clearly that loans which have been charged off and deducted by a creditor are no longer capital assets and recovery thereon must be treated as income.

Such was also originally the view of the Board. See *Lake View Trust and Savings Bank* v. *Commissioner,* 27 B. T. A. 290. The change in the Board's views on this question may be due to two rulings of the Treasury Department which were in effect for a brief time and which held that when deductions were not offset by taxable income the subsequent recovery should not be taxed. But those rulings have been superseded by G. C. M. 22163, *supra,* which holds that an offset of taxable income is not necessary, and that the correct view was that expressed in *Lake View Trust and Savings Bank* v. *Commissioner, supra.*

CONCLUSION

The Board's decision is erroneous and should be reversed.

Respectfully submitted.

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